GOING BEYOND

FORM 433-A

PROTECTING ASSETS IN AN OFFER IN COMPROMISE

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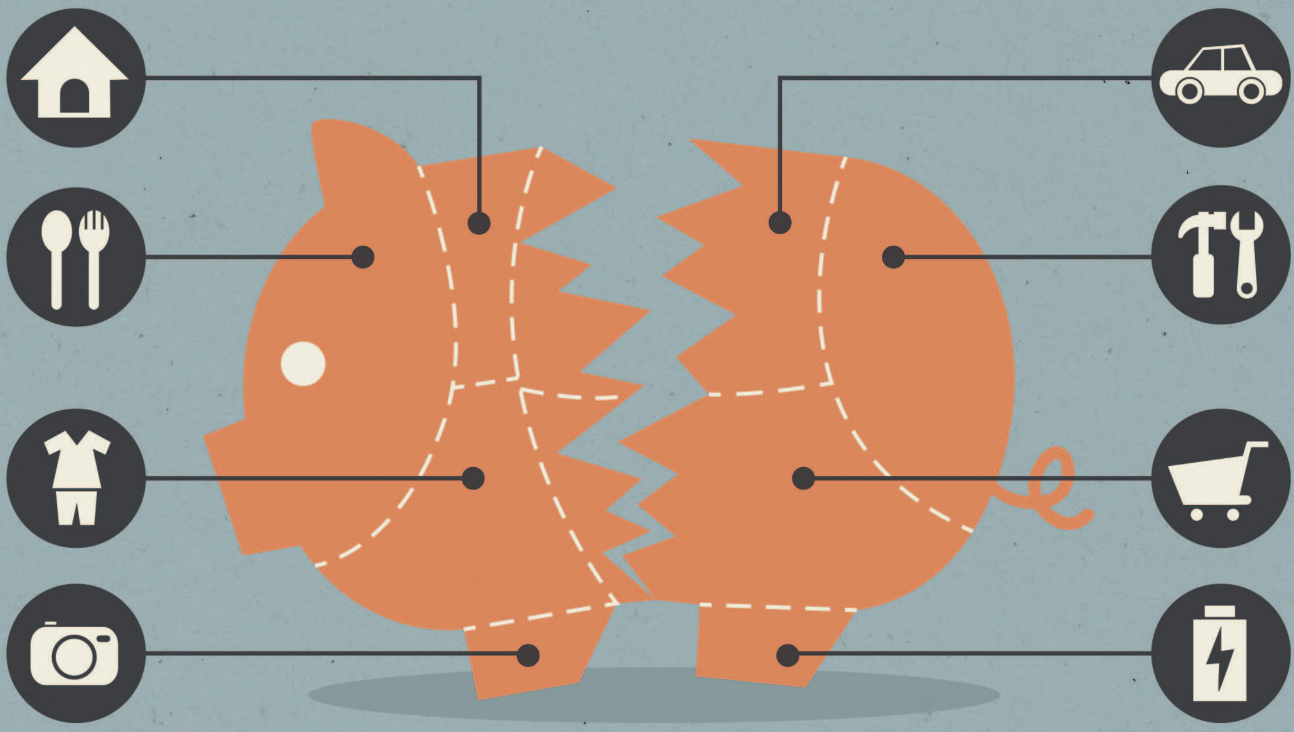

The formula the IRS uses to value an offer in compromise is widely published by the IRS, both on its website and in the OIC instruction booklet. It is no secret that to settle a tax debt, the IRS wants money from two pots: the value of a taxpayer's assets and the present value of the taxpayer's ability to make monthly payments on the debt.

What is less publicized, however, are the exclusions the IRS allows in the value of assets in a compromise. The nooks and crannies of the Internal Revenue Manual and Internal Revenue Code reveal significant savings in how the IRS values automobiles, cash in bank accounts, business equipment, and household goods in an OIC.

The IRM allows a value reduction for cash in bank accounts equal to one month's living expenses. That's not all: The IRM also provides a $3,450 blanket reduction off the value of an automobile, and it permits a business to retain equipment that is critical to its operations without including the value in the settlement of the compromise.

The IRC restricts IRS' ability to seize most taxpayers' household goods and personal belongings, as well as the tools of a trade or business. These restrictions on IRS' collection power are also value reductions in an offer compromise. In other words, if the IRS cannot seize and collect from property, then the equity in that property (i.e., household goods or tools of the trade) is not included in the valuation of a compromise.

We want to save money for our clients and secure the lowest settlement possible. So let's take a more detailed look at how to claim value exclusions for automobiles, cash in bank accounts, business equipment, and household goods in an OIC, and how to incorporate those exclusions into an IRS financial statement, Form 433-A (Collection Information Statement for Wage Earners and Self-Employed Individuals).[1]

Automobiles

Don't claim the full value of your client's automobile on Form 433-A for an offer in compromise without first reading IRM 5.8.5.12. This provision allows for a blanket exclusion of $3,450 from the quick sale value (QSV) of an automobile that is used by a taxpayer for work, the production of income, or the welfare of a taxpayer's family. For taxpayer's with joint tax liabilities, this value reduction is for two cars—$3,450 for each primary automobile driven by a taxpayer (one vehicle limitation for each taxpayer).

Let's run through an example of how to value an automobile in an OIC and incorporate the IRM exclusions into Form 433-A.

Example: Your client owns a 2006 Toyota Camry with 106,000 miles, purchased new in 2006 in very good condition. The Kelly Blue Book private party value is $6,500, and there is $1,300 owed on the original loan from the purchase of the car. The monthly payment on the car is $235/month.

Result: In an offer in compromise, the IRS wants the net realizable equity in an asset, and for a car, that's usually less than the actual value. Here's how we value the Camry to arrive at net realizable equity on Form 433-A, Line 18a, Personal Vehicles:

- **First step: Fair market value.** Go to KBB.com for the Kelly Blue Book private sale value of the vehicle. In our example, that is $6,500, which we consider to be the fair market value. Now let's start taking our value exclusions to get to net realizable equity.
- **Second step: Reduce to quick sale value.** The IRS allows us to reduce the FMV of most assets, including cars, to the QSV. *See* IRM 5.8.5.4.1. To the IRS, QSV represents the price a seller could get for an asset if it had to be sold quickly under financial pressure. The standard IRS reduction for QSV is 20 percent, although a greater percent can be used if a reason is demonstrated as to limited marketability of the asset. In our example, the Camry is readily marketable, so using the $6,500 as the FMV, a 20 percent reduction gives us a value of $5,200.
- **Third step: Claim $3,450 exclusion.** Claim the IRM 5.8.5.12 blanket allowance for the $3,450 exclusion against the

value of the car. This further reduces the value to the Camry in an OIC to $1,750 ($5,200 QSV less $3,450).

- **Fourth step: Subtract loan balances.** Subtract the balance that remains due from the purchase of the Camry. The remaining balance on the loan is $1,300, resulting in a net realizable equity for purposes of an OIC of $450 ($1,750 less $1,300). (Yes, we have just used the Internal Revenue Manual to reduce the compromise value of the Camry from $6,500 to $450, net realizable equity.)
- **Fifth step: Completing Form 433-A, Line 18a, Personal Vehicles.** Complete Form 433-A for the Camry, showing the net realizable equity at $450. It is good practice to show the IRS your calculations and citations, either by attaching a form to the 433-A or on the form itself, space permitting, as shown in Table 1.

After reductions to quick sale value, taking the $3,450 exclusion permitted in the IRM, and subtracting the loan balance, the net realizable equity of the $6,500 Toyota Camry is $450. The offer will consider the Camry to be an asset worth $450, the net realizable equity.

Bank Account Balances

The cash balances in our clients' personal bank accounts are an asset for purposes of valuing the compromise—it is money on hand, a valuable asset, no different from equity in a house or vehicle.

But don't offer the IRS the full value of the balances in a taxpayer's bank account in a compromise. Be sure to claim the value exclusion for bank account balances found in IRM 5.8.5.7. The bank account exclusions apply to savings accounts and checking accounts.

For savings accounts, IRM 5.8.5.7 provides an exclusion of $1,000 from the cash balance in the account. The IRS will usually require the last three months' bank statements for review. If the account has minimal withdrawal activity, use the balance on the most recent statement on Form 433-A, less the $1,000 exclusion.

For checking accounts, a taxpayer is entitled to exclude one month's allowable living expenses from the value of a compromise. If there are no savings accounts, the IRM allows the $1,000 savings exclusion to be added to the amount excludable from a checking account. In other words, the IRS will allow your client $1,000 plus enough money to pay one month's allowable living expenses, and will not include those funds as a cash asset in the value of the offer. These exclusions apply only to individual bank accounts, not business accounts.

The IRS will usually require a minimum of three months' checking account statements, and will usually use the average daily balance in the account over that time as the value of a checking account.

For purposes of the checking account value exclusion, the IRS defines "one month's allowable living expenses" as those expenses that are within the IRS allowable expense standards. The intent of the allowable expense standards is to limit a taxpayer's expenses—and increase his cash flow—to amounts the IRS publishes as reasonable. Common expenses that are limited by the IRS include housing and utilities, auto payments, as well as food, clothing, and entertainment.

Here's an example of how to use the IRS bank account exclusions on Form 433-A for an offer in compromise:

Example: Your client does not have a savings account, but does have a checking account that is used for everyday bill paying. The average balance in the account over the last three months is $7,000. Living expenses total $4,500, all of which fall within the IRS schedules of standard allowable expenses.

Result: Even though the account has $7,000 in it, on Form 433-A, Line 13a, Bank Accounts, the net realizable equity for purposes of the compromise would be shown as $1,500. The calculation is as follows: $7,000 (average balance), less $4,500 (allowable living expenses for one month), less $1,000 (IRS exclusion) = $1,500. Show your work and how you arrived at the net realizable equity for purposes of the account balances on Form 433-A or on an attachment, as shown in Table 2.

Table 1. Calculating Net Realizable Equity for Automobiles

Year	Make/Model	Purchase Date	Fair Market Value	Loan Balance	Payment	Equity
2006	Toyota Camry 106,000 miles	June, 2010	$6,500	$1,300	$235	$450

Equity calculation: FMV is $6,500. QSV is $5,200 (20% reduction), less $3,450 exclusion per IRM 5.8.5.12, less $1,300 financing encumbrance = $450 net realizable equity.

Table 2. Calculating Net Realizable Equity for Bank Accounts

Type of Account	Name of Bank	Account Number	Account Balance
Checking	Wells Fargo	xxxx0134	$1,500

Equity calculation: $7,000 (average balance), less $4,500 (allowable living expenses for one month per IRM 5.8.5.7), less $1,000 (IRS exclusion) = $1,500 FMV.

Don't overvalue a compromise by offering actual bank account balances; it can be challenging to go down from an offer that is too high. Apply the exclusions in IRM 5.8.5.7 to get the best settlement value for your clients.

Business Equipment

If your client is self-employed and has large business equipment, carefully review IRM 5.8.5.15, "Income-Producing Assets," before completing Form 433-A and submitting an offer in compromise. Here's why: The IRS has a general policy against simultaneously including both the net realizable equity in business equipment and the revenue that the equipment generates into the value of an OIC. Subject to the discretion of the offer investigator, IRS policy is to include *either* the equity in the equipment or the revenue the equipment generates into the offer valuation, but not both.

The determination of whether equipment can be excluded from the value of a compromise is based on whether the asset is critical to business operations.

If the equipment is critical to operations, IRM 5.8.5.15 *excludes* the equity in the asset from the compromise valuation but *includes* the revenue the equipment generates in the business' cash flow to calculate ability to pay. (*See* IRS Internal Guidance Memorandum for Offer in Compromise from Scott Reisher, director, IRS Collection Policy, Dated May 21, 2012, Control SBSE-05-0512-041.)

The IRS has expressed a desire to work with taxpayers to maintain business operations, particularly in a lumbering economy, and not force liquidation of assets that would affect business operations to fund a compromise.

What makes an asset critical to business operations? Although this is a facts-and-circumstances test, IRM 5.8.5.15 provides the following situational example to guide us:

> *A business depends on a machine to manufacture parts and cannot operate without this machine. The equity is $100,000. The machine produces net income of $5,000 monthly ($60,000/year). The reasonable collection potential (RCP) should include the income produced by the machine, but not the equity. Equity in this machine will generally not be included in the RCP because the machine is needed to produce the income, and is essential to the ability of the business to continue to operate.*

In this example, the IRS would consider excluding the equity in the machine from the valuation of the compromise, as it was demonstrated that the machine is critical to business operations. The IRS does not want to upset the business' ongoing operations, so it will factor the positive cash flow the equipment generates into the monthly ability to pay valuation, but will not add the value of the asset itself to the compromise.

Conversely, if the business did not need the machine, or the product it produced resulted in very minimal revenue (i.e., $500/month), the IRS would include the value of the equipment in the compromise, but would not include the small income it generated into a cash flow analysis of ability to pay. The IRS is essentially agreeing to take the value of the asset or the cash flow it generates, but not both.

The IRC provides additional methods to exclude smaller equipment and tools of a business from the value of an offer in compromise. IRC Sec. 6334(a)(3) exempts from levy the books and tools of trade, profession, or business up to $4,470 in value. If the IRS cannot seize and collect from property, then the equity in that property (i.e., business tools) is not included in the valuation of an offer in compromise. (*See* also IRM 5.8.5.16, "Inventory, Machinery, Equipment, and Tools of the Trade," which recognizes the use and application of the statutory exemption of IRC 6334(a)(3) to exclude the value of small business equipment and tools in an offer in compromise.)

Here's an example of how to use IRC 6334(a)(3) in an offer in compromise:

Example: Your client is a self-employed contractor who has tools of the profession—ladders, hand tools, small equipment, a computer, etc.—that is valued at $5,700.

Result: Even though the small tools and equipment are worth $5,700, on Form 433-A, Line 66a, Business Assets, the net realizable equity for purposes of the compromise would be shown as $90. The calculation is as follows: FMV is $5,700. QSV is $4,560 (20 percent reduction), less $4,470 exclusion per IRC 6334(a)(3) and IRM 5.8.5.16 = $90 net realizable equity. Show your work and how you arrived at the net realizable equity on the Form 433-A or on an attachment, as follows:

- **First step: Fair market value.** Based on the age and condition of the equipment and what the cost would be if purchased new, you accept your client's appraisal of $5,700 as the depreciated value. The IRS wants net realizable equity in the compromise, which we are about to see will be less than the actual value.
- **Second step: Reduce to quick sale value.** To arrive at net realizable equity, the IRS will allow a 20 percent reduction from the FMV to account for a theoretical quick sale of the property. The 20 percent reduction yields a QSV of $4,560.
- **Third step: Claim $4,470 exclusion.** Claim the $4,470 exclusion permitted in IRC Sec. 6334(a)(3) and IRM 5.8.5.16 against the quick sale value of the tools and equipment. This further reduces the value of the property in the OIC to $90 ($4,560 less $4,470).
- **Fourth step: Completing Form 433-A, Line 66a, Business Assets.** Complete Form 433-A for your values, showing the net realizable equity at $90. As always, it is good practice to show the IRS your calculations, either by attaching a form to the 433-A or on the form itself, space permitting, as shown in Table 3.

Household Goods and Personal Belongings

Contrary to popular belief, the IRS cannot levy every single item of our clients' personal property and leave them without basic essentials. Sec. 6334(a)(2) of the Internal Revenue Code lists specific types of property that are protected from seizure, including clothing and necessary household furniture and belongings.

In other words, the IRS is not taking our clients' clothing, televisions, beds, dressers, tables, or Christmas ornaments. Currently, IRC Sec. 6334(a)(2) protects $8,940 in value of household goods and personal effects per taxpayer. These restrictions on IRS' power to seize should be remembered and utilized when it is OIC time. Good practice requires a claim on Form 433-A to exclude up to $8,940 in household goods and personal effects.

As to clothing, Sec. 6334(a)(1) of the Internal Revenue Code allows our clients to keep all their necessary clothing. Bear in mind that the tax code uses the word "necessary" in describing the clothing that is exempt from IRS collections, meaning that the IRS can technically take clothing that is not necessary. It is likely the IRS' opinion that furs, for example, are not protected from seizure.

IRM 5.8.5.11 incorporates IRC Sec. 6334(a)(2) into IRS policy, and specifically instructs offer investigators to apply the statutory exemptions from seizure for furniture, personal effects, and clothing as value exclusions in an offer in compromise.

In valuing clothing, household goods, and personal effects, garage sale valuations control as the equivalent of fair market value—in other words, what is the charitable donation value of the property?

Example: Your client has a three bedroom house, with a living room, family room, and kitchen. All items in the house are more than ten years old and have no antique value. A good faith estimate on the value is $3,500.

Result: Household goods are reported on Form 433-A, Line 19a, Personal Assets, and have no added value to the compromise as they are fully excluded pursuant to IRC Sec. 6334(a)(2) and IRM 5.8.5.11, as shown in Table 4.

Example #2: Household goods are valued at $12,000 for a single taxpayer.

Result: As the $12,000 value is over the excluded amount of $8,940, the equity for purposes of the compromise would be $3,060,

Table 3. Calculating Net Realizable Equity for Smaller Business Equipment

Description	Purchase Date	Fair Market Value	Loan Balance	Payment	Equity
Hand tools, small equipment	Various	$5,700	N/A	N/A	$90

Equity calculation: FMV is $5,700. QSV is $4,560 (20% reduction), less $4,470 exclusion per IRC Sec. 6334(a)(3) and IRM 5.8.5.16 = $90 net realizable equity.

Table 4. Calculating Net Realizable Equity for Household Goods, Example #1

Description	Purchase Date	Fair Market Value	Loan Balance	Payment	Equity
Household goods	Various	$3,500	N/A	N/A	Excluded

Location: 21 Holiday Rd, Warren, Ohio. All household goods and personal effects claimed as excluded under IRC Sec. 6334 and IRM 5.8.5.11.

calculated as follows: $12,000 FM less 20 percent QSV = $10,000 less $8,940 exemption = $3,060 net realizable equity. Note the claim on Form 433-A, Line Item 19a, Personal Assets, and how you calculated the equity, as shown in Table 5.

If Example #2 had joint taxpayers, there would be no net realizable equity as each taxpayer would be able to claim an $8,940 exclusion, which is greater than the value of the property. **EA**

Table 5. Calculating Net Realizable Equity for Household Goods, Example #2

Description	Purchase Date	Fair Market Value	Loan Balance	Payment	Equity
Household goods	Various	$12,000	N/A	N/A	$3,600

Location: 21 Holiday Rd, Warren, Ohio. Household goods and personal effects claimed as excluded under IRC Sec. 6334 and IRM 5.8.5.11 up to $8,940, resulting equity is $3,060 ($12,000 – $8,940).

ENDNOTE

[1] It is the author's experience that the IRS accepts either the Form 433-A or Form 433 (OIC) as a collection information statement in an OIC. Accordingly, references for purposes of this article are to Form 433-A.

About the Author:

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